

16 December 2014

Via email

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Dear Mr Roberts

**JGN 2015-20 access arrangement draft decision – rate of return and gamma**

As noted in my letter of 12 December 2014, we are keen to ensure Jemena Gas Networks' (JGN) revised access arrangement (AA) proposal is targeted at matters of substance and also provides sufficient evidence for the AER to consider our revised proposal. To assist us in meeting these objectives, I am writing to seek clarity on certain statements made, and conclusions drawn, in the AER's draft decision for JGN.

For timeliness and manageability, this letter relates to:

- the rate of return, and
- the value of imputation credits, or gamma.

**Attachments A and B** include questions for each of these respectively. Two general questions on stakeholder submissions and AER analysis are below.

We may seek further clarification on other areas of the draft decision in the coming weeks.

*Stakeholder submissions made on other regulatory proposals*

The draft decision for JGN cites a number of submissions made by stakeholders on proposals by the ACT and NSW electricity networks. For instance, the notes below figure 3-4 refers to:<sup>1</sup>

*See: UnitingCare, Submission to the NSW distribution network service providers' regulatory proposals for 2014–19, September 2014, pp. 19–20; UnitingCare, Submission to ActewAGL's regulatory proposal for 2014–19,*

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<sup>1</sup> AER, JGN 2015-20 draft decision, Attachment 3 rate of return, p. 3-33.

*September 2014, pp. 19–20; Origin Energy, Submission to ActewAGL's regulatory proposal for 2014–19, August 2014, p. 4.*

We seek clarification on whether and, if so, how each of these submissions—and any others referred to the draft decision that were not made directly on JGN's proposal—are relevant to JGN's access arrangement review.

*AER analysis referred to as the source for figures and tables*

The AER draft decision refers to 'AER analysis' as the source for a number of figures and tables throughout the rate of return and gamma appendices and attachments. For instance, AER analysis is identified as the source for:

- Figure 3-3 Comparison of the AER's equity beta range and point estimate with Henry's 2014 report and submissions
- Figure 3-4 Other information comparisons with the AER allowed ERP
- Figure 3-7 Comparison of equity and debt premiums
- Figure 3-8: Total risk premium from relevant expert reports over time
- Figure 3-9 Equity risk premium comparison
- Figure 3-10 Comparison of alternative historical debt data series
- Figure 3-11 Comparison of RBA and BVAL 7 year curves
- Figure 3-12 Impact of adjustments to the published 10 year RBA yields
- Figure 3-13 Impact of adjustments to the published 7 year BVAL yields
- Figure 3-14 Dividend yields
- Figure 3-16 State government bond spreads over government yields
- Figure 3-17 Implied volatility (VIX) over time
- Figure 3-18: Movements in SFG's dividend growth model
- Figure 3-19 Number of equity beta estimates from Henry's 2014 report
- Table 3-20 Relevant independent valuation (expert) reports
- Table 3-21 Recent broker reports
- Table 3-41 MRP estimates under dividend growth models, 0.6 theta (per cent)
- Table 3-59 Median credit rating for AER sample over different time periods.

We seek copies of the data or analysis used to populate these tables and figures at your earliest convenience, and by no later than **Friday, 6 January** to support our review of the draft decision and our revised AA proposal, due to the AER on 27 February 2015.

We wish to meet with the AER to discuss these matters and those in the attachments, prior to receiving your written response, to ensure they are clear. Please feel free to contact me on (03) 8544 9053 or at [robert.mcmillan@jemena.com.au](mailto:robert.mcmillan@jemena.com.au) or Eli Grace-Webb on (03) 8544 9164 or at [eli.grace-webb@jemena.com.au](mailto:eli.grace-webb@jemena.com.au) if you would like to discuss these issues further.

Yours sincerely

A handwritten signature in black ink, appearing to read 'R. McMillan', with a long horizontal flourish extending to the right.

**Robert McMillan**  
General Manager Regulation  
Jemena Limited

## Attachment 1 – Rate of return questions

### *Cost of equity*

1. JGN understands from the draft decision that the AER does not consider that the return on equity estimate from the Sharpe Lintner CAPM (SLCAPM) will be downward biased, given the AER's selection of input parameters. Could the AER please clarify whether:
  - a. it considers that the SLCAPM will not produce downward biased estimates of the return on equity in any circumstances; or
  - b. it considers that the SLCAPM may produce downward biased estimates of the return on equity, but that the way in which the AER has selected input parameters means that it will not produce downward biased estimates in the AER's application.

If it is the latter, then could the AER please clarify how it considers that the bias in the SLCAPM has been corrected for in the AER's application of the model?

2. We understand from the draft decision that the AER considers that businesses operating under a revenue cap will be more shielded from systematic risk. How does the AER account for differences between JGN (which is subject to price cap) and revenue cap businesses in terms of their exposure to systematic or other risk, either in estimation of the equity beta and/or in determination of the appropriate credit rating, or in any other way?
3. The draft decision appears to place similar reliance on the SFG analysis of 56 foreign comparators over many years as that placed on the FTI study of 3 comparators when determining equity beta. Does the AER consider the reliability of these two studies are the same or materially similar such that similar reliance can be placed on them?
4. The draft decision includes a range for equity beta of 0.4 to 0.7 before a final estimate of 0.7 is selected. Can the AER please provide the source for the 0.4 and the 0.7? Would the final estimate change if the upper value of the range (i.e. the 0.7) were higher or lower?
5. The explanatory statement to the rate of return guideline notes that consideration of the Wright approach 'is expected to lead to more stable estimates of the return on equity than under our previous approach'.<sup>2</sup> The AER notes that it applied this guideline to estimate the return on equity in the draft decision. Can the AER please confirm whether, and if so, how and to what extent, its consideration of the Wright approach in the draft decision has led to more stability in its allowed return on equity than under its previous approach?
6. The draft decision cites concerns about the potential for data mining when using the Fama-French three factor model and the Black CAPM to estimate the cost of equity.<sup>3</sup> Can the AER please clarify whether this concern is with the development of the models, their application, or both?

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<sup>2</sup> AER, December 2013, *Rate of return guideline explanatory statement*, p. 66.

<sup>3</sup> AER, *JGN 2015-20 draft decision, Attachment 3 rate of return*, pp. 3-53 and 3-57.

7. The draft decision notes that '[f]or our benchmark efficient entity with a similar degree of risk as TransGrid, we would not expect the return on equity to be a long way above the prevailing return on debt'.<sup>4</sup> Can the AER please clarify whether this statement should refer to Jemena Gas Networks instead of TransGrid? If not, can the AER please clarify why this is relevant for the draft decision?
8. The AER acknowledges that the SL CAPM has weaknesses.<sup>5</sup> Can the AER please clarify what these weaknesses are?

*Cost of debt*

9. The draft decision notes that it released a PTRM for consultation that provides enough flexibility to implement the return on debt approach. We understand this PTRM is required for electricity NSPs. Can the AER please clarify how this is relevant for our decision and whether it is comfortable with the flexibility to implement the return on debt approach built into JGN's proposed revenue forecast model?
10. The draft decision raises concerns over further complexity and cost of having a process to determine an averaging period each year of regulatory period rather than all at the start. Can the AER clarify what complexity and costs it expects from such a process?

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<sup>4</sup> AER, *JGN 2015-20 draft decision, Attachment 3 rate of return*, 3-97.

<sup>5</sup> AER, *JGN 2015-20 draft decision, Attachment 3 rate of return*, 3-171.

## Attachment 2 – Gamma questions

1. JGN understands from the draft decision that the AER defines theta as ‘the before-personal-tax and before-personal-costs value of imputation credits to investors’, and on this basis concludes that any investor that is ‘eligible to fully utilise imputation credits’ should value each dollar of imputation credits received at one dollar.
  - a. Can the AER please clarify what is meant by the ‘before-personal-tax and before-personal-costs value’ of imputation credits?
  - b. Can the AER please clarify what is meant by an investor that is ‘eligible to fully utilise imputation credits’?
  - c. Are there particular classes of investor that the AER considers would be ‘eligible to fully utilise imputation credits’?
  - d. Does the AER assume that all Australian investors are eligible to fully utilise imputation credits?
2. The AER considers tax statistics studies, equity ownership statistics, and dividend drop off studies when determining an appropriate value of theta. Can the AER please confirm whether it considers theta represents the proportion of distributed credits that are redeemed or capable of being redeemed or the price that those credits would trade at if there was an open market for them?
3. In his report (Advice on the Value of Imputation Credits) published with the draft decision, Associate Professor Handley explains that:<sup>6</sup>

*I have previously suggested that estimates of utilisation rates from taxation statistics can be interpreted as a reasonable upper bound estimate of the value of theta. The purpose for including the “upper bound” part was simply to convey the fact that the ultimate source of value of a distributed franking credit is the amount of personal tax saved as a result of redeeming the credit – something which is given by taxation statistics data. In other words, value can only be realized by “redeeming” the credit at the ATO.*

Does the AER consider that taxation statistics provide an upper bound on the value of distributed imputation credits? If not, can the AER please explain how this value may exceed the utilisation rates from these taxation statistics?

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<sup>6</sup> Handley, J, 29 September 2014, *Advice on the Value of Imputation Credits*, p. 39.